SCHLINDWEIN ASSOCIATES
INVESTMENT COUNSEL

Bonds

In a portfolio broadly diversified to manage risk, each of the primary asset classes – money markets, bonds, stocks – plays a particular role. For money markets, it is safety of principal with some yield. For stocks, it is growth with some income. The historical role for bonds has been income greater than in money markets with price risk less than in stock markets. Since the Great Recession of 2008-09, bonds have fulfilled their yield objective but at much lower levels. More recently, bonds have generated price risk at a much higher level. A review of bond yield trends and the mechanics of the bond investment itself can provide perspective for investing ahead.

PERSPECTIVE

The long, secular trends of U.S. Treasury bond yields over the past seven decades are shown in Chart I. In a 27-year stretch following WWII to the inflationary spike of the 1980s, bond yields rose dramatically, from a low of 2.6% to a high of 15.1%. Once aggressive monetary policy broke inflation, bond yields began an equally dramatic downtrend, reaching a low of 1.1% 39 years later. This trend has been broken with the return of higher inflation and restrictive monetary policy. Bond yields have reached 4.7%, well above the 70-year low but still below the average of 5.8%. The pattern of very long and opposite trends renders this average yield less meaningful.

The total return (income plus price change) from a bond investment held to its maturity is the yield at purchase. But the return outcome can vary widely if the bond holding is sold prior to maturity. Bond yields and prices move in opposite directions. As yields fall, prices rise and vice versa. This relationship is shown in Chart II, tracking the yield and price movements of a rolling 20-year maturity U.S. Treasury index since 1975. Also shown is the trend in bond duration, the measure of a bond's price sensitivity to changes in yields throughout its maturity. For example, a duration of 10 indicates a bond's price will change by 10% with every 100 basis point (1%) change in yield. The most recent rise in bond yields has resulted in a stunning -49% price decline for the 20-year U.S. Treasury bond.

The interplay of yield, duration, price and total return for the U.S. Treasury 20-year bond is shown in Table I. The relationship between projected and actual returns reflects duration dynamics. Duration rises and falls as yields fall and rise. At the 1981 high in bond yields, duration had fallen to 6.75, greatly reducing price risk and opportunity. Similarly, at the 2020 low in bond yields, duration surpassed 18, 2.7 times higher bond price sensitivity to changes in yields. Looking forward from today, the increase in bond yields has improved their return opportunity and the price sensitivity to further changes in bond yields has lessened. The bond risk/reward tradeoff is a bit more balanced.

INVESTMENT IMPLICATIONS

For a portfolio to reach its objectives, each investment must fulfill the role for which it was included. An over-valued investment will be challenged to do so. Until recently, such was the case for bonds, particularly those with a longer duration. Yields were too low relative to rising inflation, and price risk emerged as yields rose. The trends in economic activity and inflation will determine the course of bond yields and potential bond returns ahead. Uncertainty with respect to these trends suggests a cautious approach to bond duration for now.

CHART I

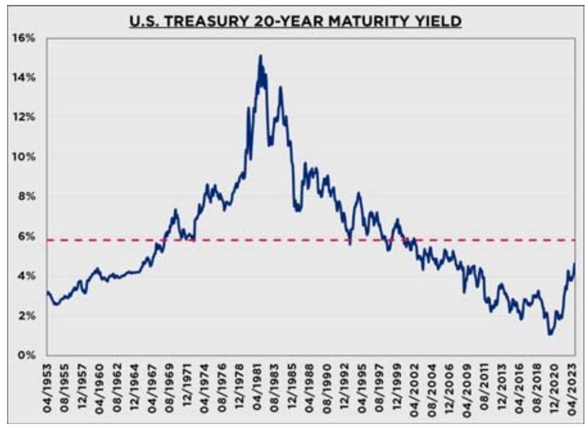

CHART II

TABLE I

U.S. TREASURY 20-YEAR MATURITY

			One-Year Return Projections			
Date	Yield	Duration	Yields Fall 100 Basis Points	No Yield Change	Yields Rise 100 Basis Points	Actual Annualized Return
Dec-1976	7.30%	10.81	18.11%	7.30%	-3.51%	-4.00%
Sep-1981	15.07%	6.75	21.82%	15.07%	8.32%	10.47%
Jul-2020	1.09%	18.03	19.12%	1.09%	-16.94%	-16.96%
Sep-2023	4.65%	13.23	17.88%	4.65%	-8.58%	